Analyst
Hillary Ho Li Ling
+6565311517
hillaryho@phillip.com.sg

Fears over faltering growth seems overdone

Executive Summary

- **United States:** The housing sector has shown some improvement, however is still plagued by a glut of unsold properties which is suppressing prices and an unemployment rate that is stuck above 9%. The new initiative to help borrowers to refinance mortgages regardless how underwater their homes are is unlikely to stop the bleeding in home prices. U.S. still faces a number of obstacles and growth could slow again.

- **China**: Threats to growth remains and they do not stem solely from overseas. If economy slows more than expected, the authorities will have the room to relax the restrictions imposed on property purchases. They will also be able to reverse the tight monetary policies that have been imposed.

- **Japan**: While government spending on housing reconstruction is likely to lift the economy in the near term, there is going to be a lack of catalysts to propel economic momentum. Level of bank lending remains flat and there is a lack of demand for credit. In turn, the lack of creation of money is likely to hold the economy back.

United States

Fears over faltering growth "appears" to be overdone

The U.S. recovery appeared to be screeching to a halt in late summer, with some economists warning of a "double-dip" recession. A budget face-off in Washington and worsening debt crisis in Europe contributed to the darker mood as many economic indicators fell. Despite the doom and gloom mood, the U.S. economy grew in the third quarter at the fastest pace in a year. Gross domestic product rose at a 2.5% annual rate, up from a 1.3% gain in the prior quarter. Gains in consumer spending and business investments have helped support growth.

The U.S. economy grew in the third quarter at the fastest pace in a year. GDP rose at a 2.5% annual rate, up from a 1.3% gain in the prior quarter.

While people have said that they felt worse according to surveys of consumers' confidence, spending was not affected. Consumer spending grew at a 2.4% rate after slowing to a 0.7% pace in the second quarter. A jump in gasoline prices had weighed on consumer spending earlier in the year, and supply disruptions from Japan's earthquake had curbed auto production. Improvements in these two areas have helped lift consumptions.

Similarly, while some business surveys have pointed to a contraction in factory output, companies actually increased its investment spending during the quarter. Business spending rose at a 16.3% pace as companies spent on equipments and software.

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Apart from consumer and business spending, growth in the third quarter was also supported by a smaller U.S. trade deficit. Exports grew 4% compared to 3.6% in the second quarter while imports rose 1.9% from 1.4%. Meanwhile, government spending was flat, reflecting continued budget cuts by state and local governments. A 2% increase in federal outlays was offset by a 1.3% decline in local and state spending.

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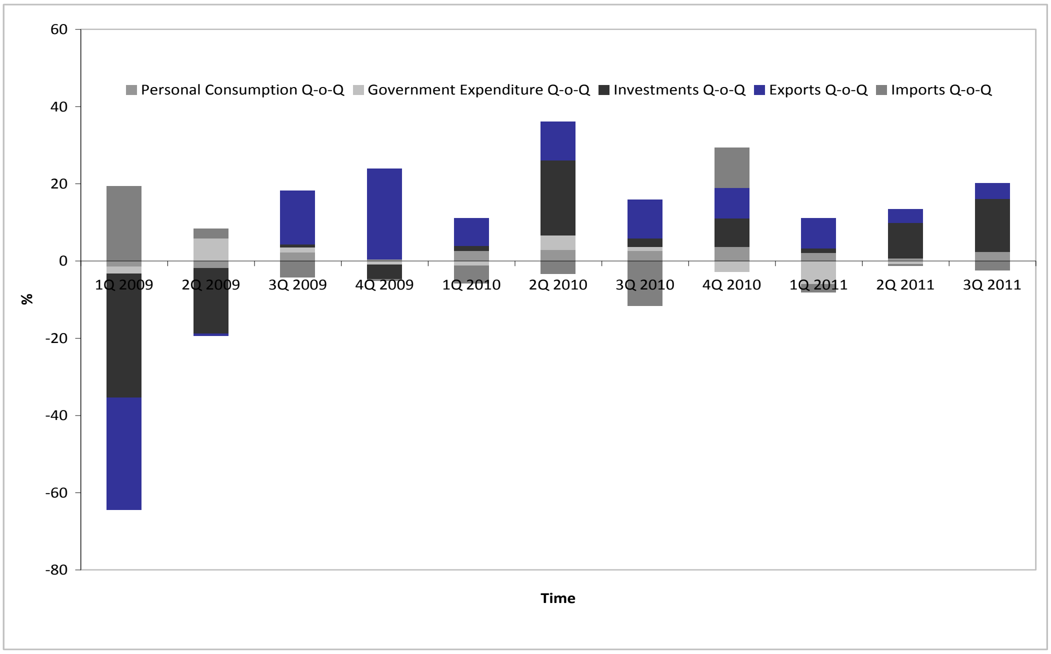
Figure 1: US GDP breakdown



Source: U.S. Bureau of Economic Analysis (BEA), as of Sep 2011.

Some positive news from the housing sector – but it is just not enough.

The housing market index (an index produce by the National Association on Home Builders (NAHB)) jumped 4 points in October to 18, a still depressed level but the highest reading in nearly a year-and-a-half. NAHB notes that gains were concentrated in selected markets where economic recovery is starting to take hold and where foreclosure activity is relatively subdued. In line with that, new single-family home sales rose in September. The Commerce Department said sales increased 5.7% to a seasonally adjusted 313,000-unit annual rate, as sales in the South logged their fastest pace since April 2010, offsetting a steep decline in the Midwest. Still, total sales of new homes are still 0.9% lower compared to a year ago. With the improvement, the supply of new homes in the market fell to 6.2 months' worth from 6.6 month in August.

Despite the improvement, significant challenges remain for the housing industry. Recovery in the housing market is plagued by a glut of unsold properties which is suppressing prices and an unemployment rate that is stuck above 9%. Moreover, prospective buyers are also discouraged by restrictive lending policies. As such, despite the recent improvement, we think that the housing market is still a distance from sustain recovery.

Meanwhile, the FHFA announced a plan known as the Home Affordable Refinance Program, which allows borrowers to refinance mortgages regardless of how underwater their homes are. This enhancement removes the current 125% loan-to-value ceiling for fixed-rate mortgages. In other words, one can have negative equity equal to the full amount of the loan or more, and still be able to refinance into current record low mortgage rates. In view of this latest initiative, we have our reservation on the plan's effectiveness in stimulating the housing sector. This plan is for current borrowers who want to get a lower monthly payment through a lower mortgage rate. It does not do anything for the borrowers who are either behind on their mortgage payments or already in the foreclosure process. It also does nothing about all those foreclosed properties sitting on the books of Fannie, Freddie and the big banks that still need to be sold and right now can only be sold at below-market prices. This plan does nothing to stop the bleeding in home prices.

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Despite the improvement, recovery in the housing market is still plagued by a glut of unsold properties which is suppressing prices and an unemployment rate that is stuck above 9%.

The new initiative to help borrowers to refinance mortgages regardless how underwater their homes are is unlikely to stop the bleeding in home prices.

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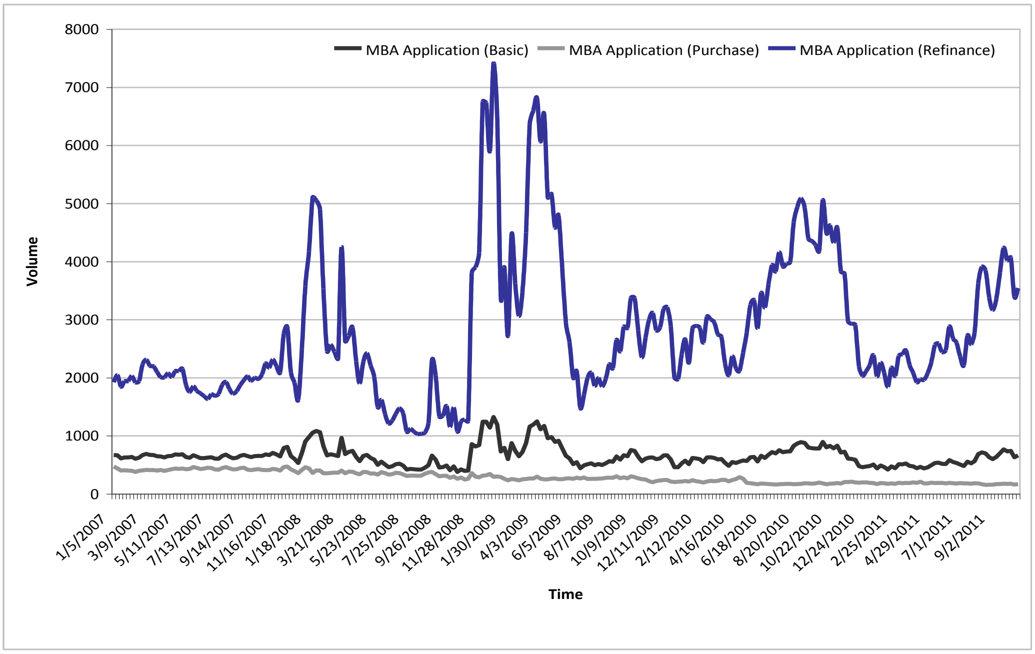
Figure 2: Refinancing accounts for a sizeable portion the MBA applications



Source: Bloomberg, as of Sept 2011.

It may give some relief to a very limited number of borrowers who may have been on the edge of trouble; however it does not stimulate home sales, save delinquent borrowers from foreclosure, stop the bleeding in home prices or rid the market of a number of distressed properties.

In all, despite a mostly positive third-quarter report, the U.S. still faces plenty of obstacles and growth could slow again. Among the reasons: worker wages are flat, hiring is slow and the nation's unemployment rate remains stubbornly high at 9.1%. Only when these internal structural problems created by the recession are resolved will the recovery strengthen and be sustainable.

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China

Manufacturing showed strengthen in October, growth in third quarter remained close to 9%

The HSBC/Markit flash manufacturing PMI estimate for October jumped to 51.1. This marks the first reading above 50 after the headline index remained below 50 for the whole of the third quarter. This indicator is a close estimate to the final reading which is announced on the first business day of each month and hence it is closely watched. Improvement in the headline figure has largely been attributed to strength in the new orders component. The overall new orders rose from 49.8 in September to 52.1 in October. Another sizeable improvement was in the output component, which rose for the third consecutive month. The rise in output may partly reflect the pick-up in new orders. It may also be attributed to the fact that companies are responding to the low level of inventories. The orders-to-inventories ratio usually moves in line with output. When the two moved away in 2009, output picked up to close the gap. In turn, this suggests that further improvement in output may be limited unless new orders rise.

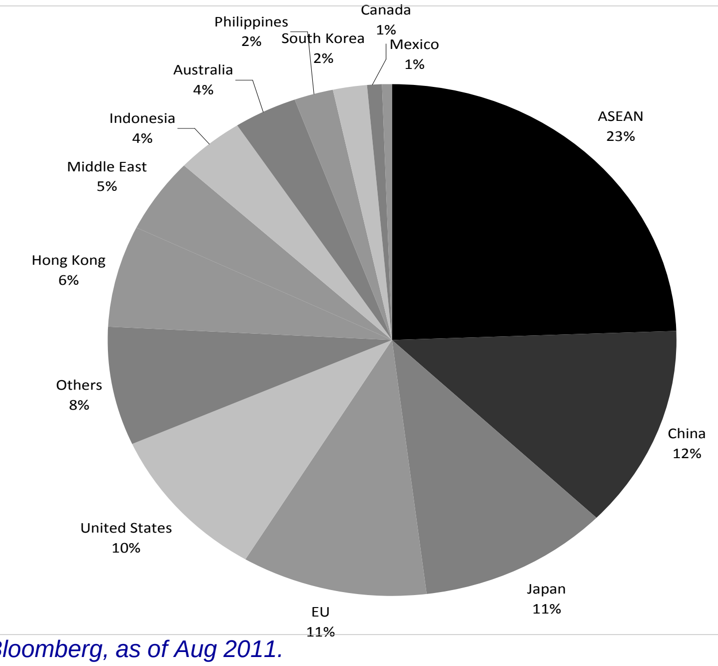
The HSBC/Markit flash manufacturing PMI estimate for October jumped to 51.1 after being below 50 for the whole of the third quarter. Improvement was largely attributed to strength in the output and new orders component.

Meanwhile, the National Bureau of Statistics reported that China's GDP expanded at a seasonally adjusted annual rate of 9.3% q-o-q in Q3 2011, down from a revised 10.1% in Q2. Still, base effects pulled the y-o-y growth rate down to 9.1% in Q3, from 9.5% in Q2. With below trend growth for several months, there have been modest hints that the policy debate is shifting. Premier Wen has recently placed greater emphasis on job creation while reiterating the fight against inflation. This suggest that as the impact of tightening now hurts, policymakers will be more mindful about balancing risks and growth prospects.

While headline inflation in China has come down to 6.1% in September from a high of 6.5% and while higher prices were largely a result of escalating pork prices, supply disruption due to the flood in Thailand may cause inflation to inch back up.

Despite so, inflation will remain a major hurdle to cross. While headline inflation in China has come down to 6.1% in September from a high of 6.5% and while higher prices were largely a result of escalating pork prices, supply disruption due to the flood in Thailand may cause inflation to inch back up. Food and machinery accounts for 13% and 40% of Thailand's total exports respectively and ASEAN and China are the major exporting destinations.

Figure 3: Thailand export destinations



Source: Bloomberg, as of Aug 2011.

More into the shadow banking system

Concerns over the extent of the entanglement of the commercial banks with the growing shadow banking sector has caused investors to dump Chinese bank shares.

Previously we wrote on the informal lending system (also know as the shadow banking system) and how the potential rise in nonperforming loans has raised concerns over the banking sector. Indeed, concerns over the extent of the entanglement of the commercial banks with the growing shadow banking sector has caused investors to dump Chinese bank shares. As a result, the Chinese government has stepped in to increase its stake in the four largest commercial banks. The move was designed to support the healthy operations and development of key state-owned financial institutions and stabilize the share prices of state-owned commercial banks.

It remains difficult to ascertain the size of the shadow banking system. There have been various guesses and these estimates have varied quite substantially. Societe Generale for instance has pointed that this sector could amount to as much as RMB 14 to 15 trillion. Other estimates have meanwhile pointed to a size ranging from 4 to 8 trillion Yuan.

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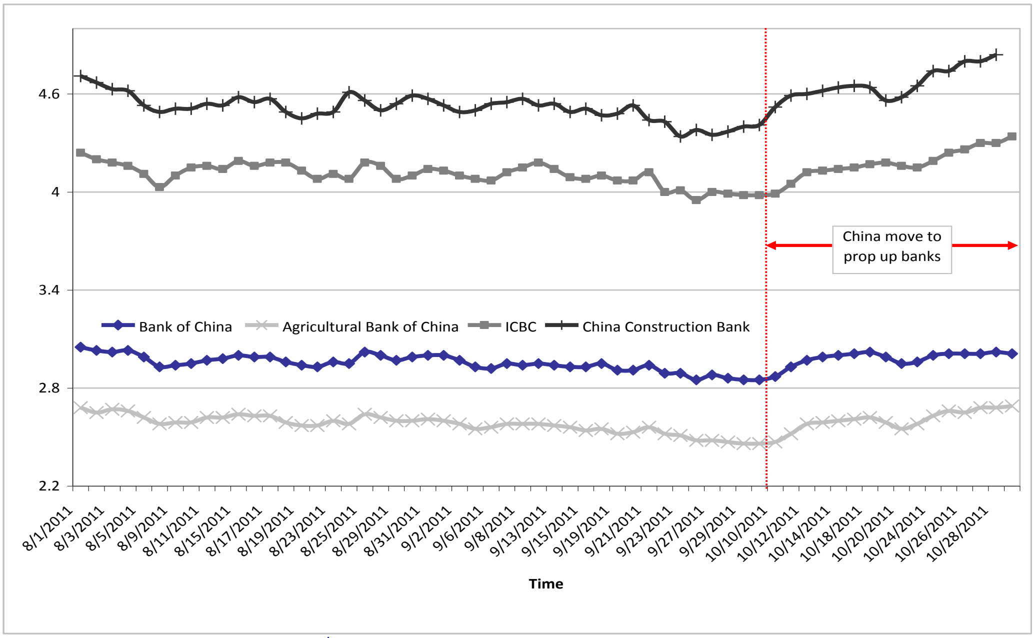
Figure 4: China move to prop up banks



Source: Bloomberg, as of 28th Oct 2011.

The situation in Wenzhou is more severe. However, we do not think that it will generate systematic risk for the Chinese banking system. This is because according to a report from Wenzhou branch of PBoC, 40% of the money, which participated in this system, comes from residents outside Wenzhou, 30% comes from local enterprises, 20% is from local residents and 10% is from the banking system. Therefore, should default level rise, the bulk of the brunt is likely to be borne by the enterprises and commoners and less so by the banks. As such, likelihood of a total collapse in the Chinese banking system seems small. While systematic risk in the banking system may be averted, consumption and investments will ultimately be affected if companies and residents were to recognize those losses in their books.

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In all, threats to growth remain and they do not stem solely from overseas. The surge in real estate investments will lead to big increase in inventories in coming months and a consequent drop in project starts. A slowdown in this sector will constitute a significant drag on growth. Nonetheless, government's efforts to increase construction of affordable housing will be able to partially offset this slowdown. If economy slows more than expected, the authorities will have the room to relax the restrictions imposed on property purchases. They will also able to reverse the tight monetary policies that have been imposed such as reducing the reserve requirement ratio. There is also the option of weakening the domestic currency.

Threats to growth remains and they do not stem solely from overseas. If economy slows more than expected, the authorities will have the room to relax the restrictions imposed on property purchases. They will also be able to reverse the tight monetary policies that have been imposed.

Japan:

Lack of demand for credit

Recovery has tailed off as activities approach pre-disaster levels. While government spending on housing reconstruction is likely to lift the economy in the near term, there is going to be a lack of catalysts to propel economic momentum. Level of bank lending remains flat and there is a lack of demand for credit. In turn, the lack of creation of money is likely to hold the economy back.

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According to Bank of Japan's latest Senior Loan Officer Survey, it showed that demand for loans was broadly unchanged from a quarter earlier. The diffusion index for households was -1 in the third quarter relative to -8 in the second quarter. Meanwhile, it was 0 in the third quarter for firms, compared to an earlier reading of -5. The results of the survey showed that while demand for credit has stopped falling, it has not edged back up. Firms have cited factors such as a fall in fixed investments and decline in sales as reasons for the lackluster demand for loans. Households on the other hand attributed the decline in demand to factors such as decrease in household consumption and housing investments. The survey also revealed that banks expect loan demand to remain largely unchanged in the last quarter of the year. This is shown in the table below. The results have signaled that increasing low cost funds availability to businesses will not necessarily boost economic activity. It is the lack of demand and not the lack of credit availability that is holding growth back.

The Japan economy should come out of technical recession in the second half of this year and this is only because the earthquake has suppressed activities this year. Authorities still have their hands tied with respect to policy stimulus. As such, Japan is likely to return to its low trend growth rate.

While government spending on housing reconstruction is likely to lift the economy in the near term, there is going to be a lack of catalysts to propel economic momentum. Level of bank lending remains flat and there is a lack of demand for credit. In turn, the lack of creation of money is likely to hold the economy back.

Table 1: How is demand for loans likely to change in three months?

How is demand for loans from borrowers likely to change over the next three months? (Number of respondents selecting each option)						
	Increase by a large extent	Increase a little	Remain about the same	Decrease by a large extent	Decrease a little	Total
Firms	1	1	47	1	0	50
Local Govt.	0	1	48	1	0	50
House-holds	0	2	45	2	0	49

Source: Bank of Japan's Q3 Senior Loan Officer Survey.

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